**POST-PRODUCTION COSTS AFTER *HYDER***

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**What is a post-production cost?**

Post-production costs are costs incurred after production but before the sale of production to market the oil and gas produced. Such costs may include costs of treating, gathering, transporting, processing, compressing, fractionating, dehydrating, etc. Most post-production costs are incurred for natural gas. Oil is sometimes treated and may be gathered or transported prior to sale.

**What is the controversy about post-production costs?**

For many years, royalty owners and oil companies have fought over whether post-production costs can be deducted from royalties. The general rule in Texas is that, absent specific language to the contrary in an oil and gas lease, a royalty owner bears no part of production costs, but does bear his/her share of post-production costs. Landowners and their counsel have tried to overcome this presumption with specific language in their leases. Oil companies have resisted. The conflict has resulted in much litigation.

The principal cases dealing with deductibility of post-production royalties under oil and gas leases are discussed below.

***Heritage Resources v. NationsBank*, Supreme Court 1996**

The question in *Heritage* was whether Heritage, the lessee, could deduct transportation costs for gas from royalties owed to NationsBank. NationsBank’s lease provided that royalties on gas would be “the **market value at the well** of 1/5 of the gas so sold or used, … **provided, however, that there shall be no deductions from the value of the Lessor’s royalty by reason of any required processing, cost of dehydration, compression, transportation or other matter to market such gas.**” The Texas Supreme Court held that Heritage could deduct transportation costs from NationsBank’s royalty. In her concurring opinion, **Justice Owen** said that the no-deductions proviso on NationsBank’s lease was “circular” and “meaningless”:

 There is little doubt that at least some of the parties to these agreements subjectively intended the phrase at issue to have meaning. However, the use of the words “deductions from the value of Lessor’s royalty” is circular in light of this and other courts’ interpretation of “market value at the well.” The concept of “deductions” of marketing costs from the value of the gas is meaningless when gas is valued at the well.

There were three opinions from the court in *Heritage*: a majority opinion written by Justice Baker, joined by Chief Justice Phillips, and Justices Cornyn, Enoch and Spector; a concurring opinion by Justice Priscilla Owen, joined by Justice Hecht; and a dissenting opinion by Justice Gonzalez, joined by Justice Gregg Abbott. (Cornyn went on to be Texas’ U.S. Senator; Justice Abbott subsequently became Texas Attorney General and is now Texas' Texas Governor; Justice Owen was nominated by President Bush to fill the vacancy on the 5th Circuit left by Judge Will Garwood’s retirement in 2001, but she was not confirmed by the Senate until 2005.)

Several amicus briefs were filed in *Heritage* asking the court to reconsider its decision, but the court refused. Justice Gonzalez, however, wrote an opinion dissenting on motion for rehearing, in which Justices Cornyn, Spector and Abbott joined. It is published at 960 S.W.2d 619. In that opinion, Justice Gonzalez said that the court was evenly divided, 4 to 4, on whether to grant the motion for rehearing. Justice Enoch had recused himself from the case, for reasons not stated, and Justices Cornyn and Spector had changed their minds, now siding with Justice Gonzalez’s dissent. And Justice Phillips had decided to concur in Justice Owen’s opinion rather than join Justice Baker’s original majority opinion. Because a vote of five justices is required to grant rehearing, the motion failed. But, said Justice Gonzalez, there was no longer any majority opinion. **“Because we are without majority agreement on the reasons supporting the judgment, the judgment itself has very limited precedential value and controls only this case.”** And, he predicted, “the Court’s error in this case will have far-reaching effects on the oil and gas industry in Texas, as millions of dollars will now be placed in dispute.” His prediction has proven true.

**Cases since *Heritage*: *Potts v. Chesapeake* and *Warren v. Chesapeake*, 5th Circuit 2014**

**Chesapeake's marketing scheme:**

Before discussing *Potts* and  *Warren*, some understanding of Chesapeake's structure is necessary. Chesapeake sells its gas to its wholly-owned subsidiary, Chesapeake Energy Marketing Inc. (CEMI). The sales contract provides that CEMI takes custody of the gas at the wellhead. CEMI then contracts with others to gather, treat and process the gas and sells the gas and liquid products extracted from the gas to various purchasers at various prices. The Chesapeake-CEMI contract provides that the price paid to Chesapeake for the gas will be the weighted-average sales price of all gas sold by CEMI from Chesapeake wells in the area, less post-production costs incurred by CEMI and less a 5% marketing fee. By structuring its sales through its affiliate and providing for the contract point of delivery to be at the wellhead, Chesapeake seeks to take advantage of its leases that provide for royalties based on “market value at the well,” as construed by *Heritage v. Nationsbank*, and leases providing that royalties will be paid on "gross proceeds received by Lessee" or "amounts realized by Lessee."

Originally, another Chesapeake subsidiary owned and operated the gathering systems through which Chesapeake sent its oil and gas, called Chesapeake Midstream Partners (in the Eagle Ford, Mockingbird Pipeline.) Chesapeake Midstream Partners charged Chesapeake Energy Marketing a fee for its services, which CEMI passed on to Chesapeake and Chesapeake deducted from royalty owners' checks. An investigative report by Pro Publica describes how Chesapeake spun off Chesapeake Midstream Partners as a separate, publicly traded entity (which became Access Midstream), in the process raising $4.76 billion. According to the report, Chesapeake sold its network of gathering lines in Pennsylvania, Ohio, Louisiana, Texas and the Midwest to Access, and entered into an agreement with Access for Access to gather and transport Chesapeake’s gas. Over a ten-year period, Chesapeake pledged by this contract to pay Access enough in fees to repay Access’s purchase price plus a 15 percent return on the investment. According to the report, the result of these transactions was to greatly increase Chesapeake’s cost of gathering its gas, to an average of 85 cents per mcf. That gathering cost greatly increased the deductions on Chesapeake’s royalty owners’ checks. In effect, it could be argued that Chesapeake has monetized some of its gas reserves by locking itself into a long-term gathering agreement with Access, in exchange for a $4.76 billion payment from Access, and in the process created an inflated gathering charge which can be passed on to its royalty owners.

The oil and gas lease in *Potts v. Chesapeake* provided that royalties on gas would be “the market value **at the point of sale** of 1/4 of the gas sold or used.” It also provided:

 **Notwithstanding anything to the contrary herein contained, all royalty paid to Lessor shall be free of all costs** and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.”

Another lease provision said:

 Payments of royalties … shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations. Royalties to Lessor on leased substances not sold in an arms length transaction shall be determined based on prevailing values at the time in the area.

Potts’ lease provides, as Justice Owen had suggested, that his royalty shall be based on the “market value at the point of sale.” But, said Judge Owen, in this case Chesapeake’s sale (to its affiliate CEMI) is at the well, so the “point of sale” is on the lease, and the market value at that point is the price received by Chesapeake from its affiliate, net of post-production costs. “Chesapeake has sold the gas at the wellhead. That is the point of sale at which market value must be calculated under the terms of the lessors’ lease.” Result: Chesapeake wins.

*Warren v. Chesapeake* also followed *Heritage*: the lease provided:

 As royalty, Lessee covenants and agrees ... (b) to pay Lessor for gas and casinghead gas produced from said land (1) when sold by Lessee, [22.5%] of the amount realized by Lessee, **computed at the mouth of the well**....

Each of the Warrens' leases also has a typed addendum attached to the preprinted form that addresses post-production costs and expenses:

 Notwithstanding anything to the contrary, herein contained, all royalty paid to Lessor shall be **free of all costs** and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation. Lessor will, however, bear a proportionate part of all those expenses imposed upon Lessee by its gas sale contract to the extent incurred subsequent to those that are obligations of Lessee.

The addendum to the Warrens' leases further provides:

 It is expressly agreed that **the provisions of this Exhibit shall super[s]ede any portion of the printed form of this Lease which is inconsistent herewith,** and all other printed provisions of this Lease, to which this is attached, are in all other things subrogated to the express and implied terms and conditions of this Addendum.

Result: "at the well" language trumps all other language under *Heritage*.-The addendum language is "suplusage." Chesapeake wins. Justice Owen wrote:

The addendum provides that if any portion of the pre-printed lease, which contains a royalty clause, is “contrary ” to or “inconsistent ” with the addendum, then the addendum supersedes the printed portion of the lease. Based on the method of calculating royalty specified in the pre-printed lease form, all royalty, regardless of where the gas sales occur, is free of post-production costs such as compression, dehydration, treatment, and transportation. That is because “the amount realized by Lessee, computed at the mouth of the well” necessarily excludes such costs. **The addendum is not inconsistent with the royalty clause in the pre-printed lease.** It says that “all royalty paid to Lessor shall be free of all costs and expenses ... including, but not limited to, costs of compression, dehydration, treatment and transportation.” The addendum does not change the point at which all royalty is computed, which is the mouth of the well. If the parties intended for the lessor to receive 22.5% of the proceeds of sales, regardless of where the sales occurred, they could have accomplished that end by any number of ways. They could have deleted the phrase “computed at the mouth of the well.” They could have said in the addendum that the lessor was entitled to 22.5% of the actual proceeds of the sale, regardless of the location of the sale. They did not.

***Chesapeake v. Hyder*, Supreme Court 2016 - 5/4 decision**

In *Hyder*, the royalty owners finally won a case in the Texas Supreme Court - although just barely. The opinion is written by Chief Justice Hecht, the only justice who was on the court when *Heritage v. NationsBank* was decided in 1996.

The Hyders' lease is unusual in reserving both a royalty and an overriding royalty. As part of the Hyders’ oil and gas lease, the Hyders agreed that Chesapeake could use their land to drill horizontal wells producing from their neighbors’ land — the surface location on the Hyders’ land, but all of the productive lateral of the well under the neighbor’s property. In exchange, Chesapeake agreed to pay the Hyders a 5% royalty on production from such wells. Because the Hyders have no mineral interest in the lands from which these wells produce, the parties referred to this royalty as an overriding royalty.

The Hyder lease had very detailed provisions for calculating the royalty, but a very brief provision on how the overriding royalty would be calculated. The Hyder lease provides that the Hyders are granted **“a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent of gross production obtained”** from such wells. The argument was over the meaning of that language. Chesapeake argued that “cost-free” meant free of production costs; the Hyders argued that “cost-free” means fee of production and post-production costs.

Chesapeake argued that “cost-free” refers only to production costs. The Hyders argued that an overriding royalty is by definition free of production costs, so “cost-free” must refer to post-production costs. Justice Hecht said that “We disagree with the Hyders that ‘cost-free’ … cannot refer to production costs. … But Chesapeake must show that while the general term ‘cost-free’ does not distinguish between production and post-production costs and thus literally refers to all costs, it nevertheless cannot refer to post-production costs.” The court held that Chesapeake had failed to make that showing: "cost-free" means free of post-production costs.

Justice Hecht’s opinion is interesting in its discussion of two other lease provisions. Although the case before the court did not encompass whether Chesapeake could deduct post-production costs from the Hyders’ royalty, Justice Hecht discussed the royalty clause. One of the provisions in the royalty clause states that the Hyders’ royalty shall be

 **free and clear of all production and post-production costs and expenses,** including but not limited to, production, gathering, separating, storing, dehydrating, compression, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred between the wellhead and Lessee’s point of delivery or sale of such share to a third party.

Remarkably, Justice Hecht considered this language “surplusage”:

 **The gas royalty in the lease does not bear post-production costs because it is based on the price Chesapeake actually receives for the gas through its affiliate … after post-production costs have been paid. Often referred to as a ‘proceeds lease’, the price-received basis for payment is sufficient in itself to excuse the lessors from bearing post-production costs.** And of course, like any other royalty, the gas royalty does not share in production costs. **But the royalty provision expressly adds that the gas royalty is ‘free and clear of all production and post-production costs and expenses,’ and then goes further by listing them. This addition has no effect on the meaning of the provision. It might be regarded as emphasizing the cost-free nature of the gas royalty, or as surplusage**.

In other words, if a lease simply says that royalty shall be based on the price received by the Lessee (or, if the gas is sold to an affiliate of Lessee, the price received by the affiliate), then the Lessee may not deduct post-production costs from the royalty. It is not necessary to add language that the royalty is “free of all post-production costs,” and in fact such language is “surplusage.”

Another provision in the Hyders’ lease disclaimed the holding in *Heritage v. NationsBank*:

 **Lessors and Lessee agree that the holding in the case of Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996) shall have no application to the terms and provisions of this Lease.**

Justice Hecht:

 *Heritage Resources* does not suggest, much less hold, that a royalty cannot be made free of post-production costs. ***Heritage Resources* holds only that the effect of a lease is governed by a fair reading of its text.** A disclaimer of that holding, like the one in this case, cannot free a royalty of post-production costs when the text of the lease itself does not do so. Here, the lease text clearly frees the gas royalty of post-production costs, and reasonably interpreted, we conclude, does the same for the overriding royalty. The disclaimer of *Heritage Resources*’ holding does not influence our conclusion.

The lesson from these cases: a royalty clause, if based on proceeds received by the lessee, should also provide that "proceeds" means the price received in the first arms-length transaction between the lessee or any affiliate of lessee in a sale to a third party which is not an affiliate of lessee. "Affiliate" should be clearly defined. *Heritage* disclaimers don't work. And always avoid "at the well" or "on the lease" language in a royalty clause.